Opinion of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 1116—August Term, 1981

(Argued May 4, 1982 Decided June 10, 1982)

Docket No. 81-6231

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

v.

AQUA-SONIC PRODUCTS CORP., UTRASONIC DENTAL PRODUCTS, INC., LEON SCHERTER, JOSHUA M. ABER, MARTIN HECHT, DENTASONIC, N.V., INVENTEL CORP., MELVIN HERSCH,
Defendants,

MARTIN E. HECHT and INVENTEL CORP.,
Defendants-Appellants.

Before:

FRIENDLY, KAUFMAN and PIERCE, *Circuit Judges.*

FRIENDLY, *Circuit Judge:*

Defendants Martin Hecht and Inventel Corporation appeal from a judgment of the United States District Court for the Southern District of New York, Sweet, *J.*, 524 F. Supp. 866 (1981), declaring that they had violated §§ 5(a), 5(c), and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77e(a), 77e(c) and 77g(a); § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); and Rule 10b-5 under the latter act, and enjoining them against future

violations. Defendants concede that if the licenses they were promoting were "investment contracts", and therefore "securities" within the meaning of § 2(1) of the 1933 Act and § 3(a)(10) of the 1934 Act, the securities laws were violated in that no registration was effected and the promotional materials omitted material information and contained material misrepresentations. We affirm the district court's holding that the licensing scheme was an investment contract and therefore a security within the 1933 and 1934 Acts.

I. Background

This case concerns a plan to manufacture and distribute new dental devices termed Steri Products. Inventor Arthur Kuris conceived of an improvement of the Cavit .n —a device that employs ultrasonic waves to dislodge plaque in the course of dental prophylaxis—which would use sterile water in place of tap water in order to reduce the risk of contamination. Kuris had discussions with one of his friends, M. Joshua Aber, a lawyer, and two of Aber's partners, Leon Schekter and defendant Hecht. The latter three formed a professional corporation called Schekter, Aber and Hecht, P.C. (SAH), and together the group established four corporations: Aqua-Sonic and Ultrasonic, New York corporations; Dentasonic, a Netherlands Antilles corporation; and Inventel, a Delaware corporation. Aqua-Sonic and Ultrasonic were each wholly owned by their respective principal officers; Dentasonic was owned by the three attorneys until November, 1978, when Kuris acquired a 19% interest; Inventel was owned by the three attorneys until February, 1979, at which time it redeemed

Schekter's and Aber's shares, leaving Hecht as the sole owner.

Upon incorporation, Dentasonic purchased from Kuris the patent and related rights to Steri Products for the United States and Canada for $406,500, payable in installments. Dentasonic in turn sold the United States manufacturing and marketing rights to Aqua-Sonic for $26 million, to be paid from a percentage of the proceeds from the sale by Aqua-Sonic of distribution licenses and from a percentage of the proceeds from the sale of Steri Products by Aqua-Sonic licensees. Until payment of the $26 million, Dentasonic retained numerous rights *vis a vis* Aqua-Sonic, including certain voting rights to all of Aqua-Sonic's stock.

The proposed method of operation was that Aqua-Sonic would sell licensees the right to sell Steri Products in certain geographical regions. Ultrasonic was described to potential licensees as an optional sales agent. Inventel entered into agreements with Aqua-Sonic wherein Inventel was to be paid $2.2 million, purportedly a finder's fee, for bringing about the arrangement between Dentasonic and Aqua-Sonic and for consulting services; Inventel was also to receive a portion of the proceeds from the sale of the licenses and from the sale of Steri products and related patents or trademarks.

The promotional materials used in discussion with potential licensees or their representatives varied over the course of the offering. From May through August of 1978, the package included:

(a) an Information Memorandum describing the Steri Products and the nature of the offering, with exhibits

attached thereto including a tax opinion letter prepared by SAH and financial illustrations projecting sales of the products and revenues.

(b) the Aqua-Sonic license and security agreement and notes payable to Aqua-Sonic (prior to inclusion of the so-called Advertising Fund to be discussed below), and related instructions.

(c) a document entitled "An Offer to Act as Sales Agent."

(d) the Ultrasonic sales agency agreement, security agreements, and notes payable to Ultrasonic (prior to inclusion of the Advertising Fund), and related instructions.

(e) a reprint of [an] article . . . from the Journal of Periodontology [concerning the contamination of ultrasonic dental units].

(f) a four-page document entitled "Confidential for Professional Use Only."

524 F.Supp. at 869. Over the next two months, the offering package was quite similar. The Information Memorandum noted in item (a) was updated. Added to the package were "two large professional photographs of what appeared to be [completed Steri Products units,] . . . a copy of a letter . . . concerning the commercial production of the Steri Products", and a copy of a letter from a dental authority that was used as an endorsement for Steri Products. *Id.* at 870. After November 1, 1978, the following documents were added:

(a) a letter dated November 1, 1978 signed by defendant Hersch with attachments relating to the creation of the Steri Products, Advertising Fund and supplemental tax opinion by SAH.

(b) a package of revised closing documents relating to the license, sales agency and Advertising Fund, and

(c) a revised summary of the offering entitled "Confidential for Professional Use Only—Summary of Revised License for Steri Products."

Id. The Information Memorandum specified the numerous obligations of the licensees, which are set out in the margin.[1]

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1. The License Agreement delineates the relationship between the parties and imposes specific duties and obligations on the Licensee. These duties include, but are not limited to: (a) vigorous promotion of the distribution and sale of the Products Parts and Supplies; (b) maintenance and employment of sufficient working capital and net worth to enable Licensee to fulfill all of his duties, obligations and responsibilities under the License Agreement; (c) employment of such agents, representatives and employees as Licensee in his sole discretion may deem to be necessary to assist him in the performance of some or all of his duties and obligations as Licensee; (d) use and maintenance of an accounting and reporting system as may be required by Licensor; and (e) use of order forms designed by Licensor and (f) adherence to certain standards for advertising materials used in connection with the business.

* * *

. . . Licensee will be an independent contractor and be solely responsible for all expenses and costs incurred by him in the conduct and promotion of his business. In addition, Licensee will be required to and be responsible for the vigorous and satisfactory promotion, distribution and sale of the Products, Parts and Supplies for use in his Territory so as to obtain a reasonable share of the market. . . . In the event that a Licensee does not satisfactorily fulfill his duties and responsibilities as set forth in the License Agreement, Licensor may elect to terminate his License.

The Memorandum did indicate that a licensee may retain "agents, representatives, employees or other persons" to assist in distribution, and added:

The choice as to whether to deal with Dental Depots and/or to retain agents, representatives, employees or others is solely that of the Licensees. The Licensor takes no position on this matter,

(footnote continued on next page)

The license was indicated to be available "only to a person who has considerable knowledge and experience in financial and business matters, [and] appreciates and understands the merits and economic risks of this business."

If a licensee accepted the "Offer to Act as Sales Agent", Ultrasonic would be responsible for all sales of Steri Products for the benefit of that licensee. Under the Ultrasonic sales agency agreement, the licensee retained the right to cancel at any time upon ninety days written notice, ultimate control over pricing and other conditions relating to orders, and the right to inspect the relevant records of Ultrasonic. However, Ultrasonic was authorized to perform all significant marketing functions, such as finding customers, taking orders, collecting proceeds, and paying expenses and taxes. Additionally, Ultrasonic was authorized to reduce the sales price unilaterally so long as its commission on the sale was reduced in the same amount. Prospective licensees were informed that "by entering into the proposed Sales Agency Agreement . . . you will derive substantial tax advantages in connection with your acquisition of a license."

Franchises for over one hundred territories were available. The fee for a typical territory was $159,500: $9,150

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for the most effective means of achieving satisfactory market penetration will vary according to the prior experience of the Licensee, the amount of time and effort the Licensee is willing to expend to exploit the License, and the nature of the Licensee's Territory.

* * *

In the event that a Licensee, in his sole discretion, elects to retain and/or employ anyone to assist him in the performance of some or all of his duties, obligations and responsibilities under the License, Licensee must undertake to actively supervise their activities on his behalf to ensure that they perform their activities in a manner which will be consistent with Licensee's activities and responsibilities to Licensor.

to be paid in cash upon the granting of the license; $9,150 in the form of a 7% negotiable promissory note due January 15, 1979; and $141,200 by a 6% non-recourse promissory note due January 1, 1985, but requiring pre-payment based upon a portion of the proceeds from the sale of Steri Products. A typical licensee entering into the sales agency agreement paid a $16,600 fee to defendant Ultrasonic: $500 in cash upon acceptance of the offer; $500 by a recourse promissory note payable on January 15, 1979; and $15,600 by a non-recourse promissory note due December 1, 1984, requiring pre-payment based upon a portion of the sales proceeds.[2] In addition, defendant Ultrasonic was entitled to a commission of 20% of the gross proceeds from sales of Steri Products.

After the offering had been available for some time, SAH created the Advertising Fund to promote the product. This purportedly increased the tax benefits available to investors. Investors in the licenses were required to contribute $400 in cash, $400 due on January 15, 1979, and $13,200 by a non-recourse promissory note due December 1, 1984, requiring pre-payment based upon a portion of the proceeds from the sales of Steri Products. The requirement of this mandatory payment did not increase the price of the overall package to a licensee choosing to accept the Ultrasonic sales agency offer because the amount payable to Ultrasonic under that agreement was correspondingly reduced. Payments made by investors prior to creation of the Advertising Fund were transferred from Ultrasonic to

2. Originally, the total fee was $30,600. The figures in text reflect the reduction to cover contributions to the Advertising Fund, to be discussed in the following paragraph.

the Fund.[3] After November 1, 1978, the Aqua-Sonic, Ultrasonic and Advertising Fund Agreements and accompanying materials were physically bound together and offered to licensees in a single package.

The tax opinion letter and supplementary statements indicated that all the payments covering the license fee, including the non-recourse notes, could be included in the licensee's basis for amortization over the eight year initial period of the licence. In addition, licensees were advised that they could deduct the full price of the sales agency agreement and Advertising Fund during 1978 and 1979. Thus, a typical investor was personally liable for approximately $20,000 but could deduct $38,000 in 1978 and $20,000 in 1979, assuming that there were not yet any sales of the product. Investors were informed that the tax benefits were greater if they retained the sales agency. In addition, two letters were sent by Aqua-Sonic advising licensees how to treat their investment on their federal tax returns.

The Aqua-Sonic licenses were marketed throughout the United States. Hecht contacted attorneys, accountants and financial planners and recruited people to sell Aqua-Sonic licenses on commission. Some of these individuals were financial consultants for some of the investors who ultimately purchased the licenses. Between May 1 and December 31, 1978, Aqua-Sonic investments were sold to 50 licensees for approximately $12,100,000, of which $900,000 was in cash and recourse notes.

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3. This method of financing the mandatory advertising arrangement could not have been accomplished, of course, were it not for the fact that all licensees up until that time had accepted the Ultrasonic sales agency option.

All 50 licensees entered into Ultrasonic sales agency agreement. None of these licensees had any exeprience selling dental products. In most cases, the territories of the licenses were not close to the licensee's residence. The promotional materials did not offer or advise of the existence of any sales agent other than Ultrasonic.

The possible applicability of the federal securities laws was brought to defendants' attention from the beginning. In the course of preparing the promotional materials, SAH sought an independent legal opinion with respect to the applicability of the securities laws to the proposed licensing scheme. SAH was advised that the arrangement might be considered an investment contract. SAH then directed one of its associates to research the issue and, after discussion, concluded otherwise. David Glasser, Aqua-Sonic's first president and sole shareholder, resigned in or about August 1978 after having been advised by his attorney that the offering might be a security under the federal securities laws and might violate other laws including antitrust and federal food and drug statutes. Leonard Suroff, who was recruited to be Ultrasonic's first president and sole shareholder and who never issued a check on behalf of Ultrasonic that was not co-signed by either Hecht or one of Hecht's partners, resigned in December 1978 because of the SEC's investigation.

The venture ultimately collapsed when mechanical difficulties prevented the timely manufacture of Steri Products. The SEC then brought this action against Aqua-Sonic, Ultrasonic, Dentasonic, Hersch, Hecht, Aber, Schekter and Inventel, seeking an injunction against future violations of the registration and antifraud provisions of

the securities laws. All the defendants except Hecht and Inventel consented to such injunctions. Judge Sweet directed, 524 F.Supp. at 867, 879-80, a similar injunction against Hecht and Inventel which we now affirm.

II. Discussion

As described above, and set out in greater detail in the district court's opinion, see 524 F.Supp. at 875, Hecht was deeply involved in virtually every aspect of the enterprise. Hecht and Inventel concede that if the licenses just described were investment contracts, the securities laws were violated in a number of ways. There was no registration of the securities. Material information was omitted from the promotional documents, including the interests of various defendants, the role of SAH, financial information relating to the use of the proceeds, and the reduced price at which licenses were offered to insiders. In addition, the market report upon which the tax opinion was based was produced in 24 hours using unverified information and was superficial with respect to key factors relevant to the tax opinion. The highly optimistic financial projections were lacking in objective support, and the product was not ready to be marketed as indicated. There had been no clinical testing, and the research materials gathered were insufficient to support the claim of the assertedly "definite causal relationship" between the use of tap water and various infections.

We thus must determine whether the enterprise described above constitutes the offering of an investment contract under the rule established in the leading case of

SEC v. W.J. Howey Co., 328 U.S. 293 (1946). As was there said, 328 U.S. at 298, "[t]he term 'investment contract' is undefined by the Securities Act or by relevant legislative reports." However,

> the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938. This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.
>
> By including an investment contract within the scope of § 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystalized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . .

328 U.S. at 298-99 (footnote 4 omitted).

It is not contested that the scheme here at issue involves "an investment of money in a common enterprise" with the expectation of profit. Rather, defendants claim that the licensees undertook important obligations, that the sales agency agreement was optional, and that even under that agreement the licensees retained significant rights, such that it cannot be said that they expected profits to be derived *solely* from the efforts of others.

The Commission argues that the Court's use of the term "solely" in *Howey* is not to be taken literally. The Ninth Circuit ruled some years ago that the "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract [since] . . . [i]t would be easy to evade[, for example,] by adding a requirement that the buyer contribute a modicum of effort." *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482, *cert. denied*, 414 U.S. 821 (1973). This was shortly followed by the Fifth Circuit in *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479-84 (1974), where Judge Gewin made a comprehensive survey of the cases in the courts of appeals and the district courts, pointed out that in the *Gopher Tire & Rubber* case cited by Justice Murphy in *Howey* the investors were required to make some efforts, and referred to one of the state cases cited in fn. 4 to the *Howey opinion*, *Stevens v. Liberty Packing Corp.*, N.J. Eq. 61, 161 A. 193 (1932), as having envisioned even more substantial investor participation. The Fifth Circuit has recently said:

4. That consideration of economic realities may not be dominant in cases concerning ordinary corporate stock, see *Golden v. Garafalo*, slip ops. 2455 (2 Cir. May 5, 1982), in no way suggests that economic realities are not controlling when determining whether an offering is an investment contract.

> the Supreme Court has altogether omitted the word "solely" in its most recent formulation of the investment contract definition. In *United Housing Foundation, Inc. v. Forman, supra* . . . , the Court quoted the investment contract definition from *Howey* and restated it as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." 421 U.S. at 852 . . . .

Williamson v. Tucker, 645 F.2d 404, 418-19, *cert. denied*, 102 S. Ct. 396 (1981). If this was intended to mean that the Supreme Court had already performed the necessary surgery on the *Howey* opinion, it would read too much into *Forman* since the Court there explicitly reserved the question whether "solely" should be taken literally, 421 U.S. at 852 n.16 (quoting *SEC v. Glenn W. Turner Enterprises, Inc., supra*, 474 F.2d 476). However, given the Court's repeated directions to consider investment schemes in light of their economic realities and the ease of circumvention of the "solely" language in *Howey* were to be taken literally, as well as the history summarized in *Koscot, supra*, we think that if faced with the question the Court would not insist on applying that language literally but would consider whether, under all the circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter's contribution in a meaningful way.

As a first step in the analysis it is useful to consider whether the allegedly optional nature of the sales agency agreements removes them from the concept of investment contracts. It has long been understood that the mere ex-

istence of such an option is not inconsistent with the entire scheme's being an investment contract. *Howey, supra,* 328 U.S. 293. Defendants assert that a major difference between their offering and that in *Howey* is that in the latter it was not economically feasible for an investor to refuse the option. Although the Court noted this, *id.* at 300, it must be remembered that 15% of the acreage sold in the scheme in that case was not covered by the optional service contracts, *id.* at 295. Thus it appears that the Court focused not on whether it was somehow possible for an investor to profit without accepting the option, or whether the investor had a bare theoretical right to reject the option, but rather on whether the typical investor who was being solicited would be expected under all the circumstances to accept the option, thus remaining passive and deriving profit from the efforts of others.

Similarly, in the instant case, while it cannot be said with certainty that prospective licensees would be wholly unable to benefit without taking advantage of the sales agency agreement, it can hardly be said that realistically the agency agreement was a mere option. In *SEC v. C.M. Joiner Leasing Corp.,* 320 U.S. 344, 352-53 (1943), the Supreme Court indicated that the relevant factors include not only the terms of the offer but also "the plan of distribution, and the economic inducements held out to the prospect." On both counts, the Aqua-Sonic offering appears to be an investment contract. The offering materials presented the license and agency agreements as a package, although within the package each was described separately and each required separate signatures. Moreover, the promotional materials indicated that additional tax benefits

would accrue to investors taking advantage of the option. This is particularly important when the license agreement itself was promoted largely for the tax advantages it offered, suggesting that the prospective licensees who could be expected to be attracted to the offering in the first instance would be ones that would find the agency agreement desirable for the same reasons.[5] Defendants seek to respond to all this by indicating that the projected cash flow for the license without the sales agency option was substantially higher than the package of the two. This statement is quite misleading, and its obvious deficiency was not lost on the fifty licensees, all of whom opted for the package. The reason for the higher cash flows without the sales agency is that the projections for the package (i.e., with the agency agreement) deduct the price of the agency option and the commissions that would be owed to the agent, whereas the projections for the license alone assume equal sales penetration with no deductions whatever for the costs of distribution. In other words, the defendants' argument implicitly assumes that an investor could duplicate the results of the sales agent and could do this without any cost. More realistically, an investor who contemplated doing his own selling would have considered the likelihood that the

5. Defendants cite *Forman, supra*, 421 U.S. at 854-55 & n.20, to support their argument that the tax aspects of the transaction are irrelevant as a matter of law. However, in that context the Supreme Court was considering what constitutes an expectation of profits. Defendants do not seriously contend that prospective licensees could not have been predicted to have an expectation of profits. The tax benefits of the transaction are relevant in that they were used as an economic inducement and thus, given the facts of this case, provide a basis for predicting the reasonable expectations and behavior of prospective licensees.

sales projections could have been achieved without using the agent, and what costs would have been entailed.

Of course, it is possible that there would be a prospective licensee who would feel capable of doing as well or better than Ultrasonic and, because of being retired or otherwise, would have had minimal costs. In *Howey*, 15% of the acreage was sold to such purchasers. In weighing this argument it is useful to consider whether the offering was directed in large part to prospective licensees who could be expected to operate their own distribution system or whether "the plan of distribution," *Joiner*, quoted *supra*, was aimed primarily at investors who could not reasonably be believed to be desirous and capable of undertaking distribution on their own. For the former, the target of the offering would be individuals or corporations with experience in selling dental products.[6] However, none of the 50 licensees had any such experience. This was not mere coincidence. The record does not indicate that any attempts were made to locate such purchasers. Hecht's leading salesman was an insurance agent and financial and tax consultant; other salesmen included a salesman in investment opportunities and an accountant. Thus, the defendants recruited salesmen would could be expected to and did contact typical passive investors, not persons with experience in the distribution of dental supplies. While it is true that in determining whether the offering is an investment contract courts are to examine the offering from an objective perspective, and therefore the acceptance of the sales agency

6. This afford an important basis for distinguishing *Mr. Steak, Inc. v. River City Steak, Inc.*, 460 F.2d 666 (10 Cir. 1972), see particularly p. 670, and other franchise cases on which defendants rely.

option by all 50 licensees is not decisive, this result is precisely what the defendants must have expected from their behavior.

Defendants' other major argument relies heavily upon the Fifth Circuit's dicta in *Williamson, supra,* 645 F.2d at 421:

> In each case the actual control exercised by the purchaser is irrelevant. So long as the investor has the right to control the asset he has purchased, he is not dependent on the promoter or on a third party for "those essential managerial efforts which affect the failure or success of the enterprise."

See also *id.* at 423-25 (discussing circumstances in which sufficient dependence might nevertheless exist). We do not consider this, standing alone, to be an accurate statement of the law. While it is true that in *Howey,* the service contracts were generally for a 10-year duration without option of cancellation, and other rights of the investors were limited in some respects, 328 U.S. at 296, the Court did not directly rely upon these factors in reaching its conclusion, see *id.* at 299-300. Moreover, it would be incongruous to attach decisive significance to mere legal formality when the Court explicitly refused to be bound by "the legal terminology in which such contracts are clothed", *id.* at 300, and preceded its conclusion with a discussion of the purposes of the securities laws, which require disregarding form for substance and placing emphasis upon economic reality, *id.* at 298-99. Finally, if it would circumvent the purposes of the securities laws to exonerate defendants who had the guile to insert the requirement that the buyer

contribute a modicum of effort, see p. 11, *supra* (quoting *SEC v. Glenn W. Turner Enterprises, Inc., supra*, 474 F.2d 476), it would be an even greater affront to the policies of these laws to exempt schemes that preserved the mere right to provide some effort.

This is not to suggest that if it was reasonable to expect investors to exercise their retained rights under the sales agency agreement in a nontrivial manner the scheme would still be an investment contract. However, in the case of the Aqua-Sonic offering, this simply was not the case. All of the preceding analysis indicating that licensees would have been expected to take the sales agency option equally suggests that they would not be likely to terminate the option and take over distribution for themselves shortly thereafter. Adding to the implausibility of such an expectation is the fact that licensees were obligated for the full price of the 8-year sales agency agreement upon acceptance; none of this fee was refundable upon termination. While it is not inconceivable that there might have been some licensees who would have made some efforts at some point in time, this is insufficient to defeat the conclusion that the scheme was an investment contract.[7]

We recognize that to write a rule precisely defining the line between contracts such as those here at issue and the typical franchise agreement, whether for Cadillacs, Coca-Cola or Kentucky Fried Chicken, may be impossible. Decision will necessarily turn on the totality of the circumstances, not on any single one. This is a situation where, in the words of Justice Holmes, "lines are pricked out by

7. Recall once again that in *Howey* 15% of the acreage was sold to purchasers not taking advantage of the service option.

the gradual approach and contact of decisions on the opposing sides." *Noble State Bank v. Haskell*, 219 U.S. 104, 112 (1911). But we have not the slightest doubt on which side of the line this case falls. Defendants sought to attract the passive investor for whose benefit the securities laws were enacted. His retention of some legal rights over distribution does not render it unnecessary for him to have the benefits of the disclosures provided in resgistration statements or the protection of the antifraud provisions. If, by contrast, the reasonable expectation was one of significant investor control, a reasonable purchaser could be expected to make his own investigation of the new business he planned to undertake and the protection of the 1933 and 1934 Acts would be unnecesary. We thus conclude that in light of the economic realities of this case and the precedents in the Supreme Court, in the state courts prior to adoption of the 1933 Act, and in the courts of appeals thereafter, the Aqua-Sonic scheme was an "investment contract" and therefore a "security".[8]

The judgment of the District Court is affirmed.

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8. Since we find the stated reasons sufficient to conclude that the Aqua-Sonic offering was an investment contract, we need not consider the merits of the "risk capital" argument, see 524 F.Supp. at 878; Jennings & Marsh, Securities Regulation 235 (1977 ed.). We likewise need not consider the relevance of the fact that here the investment was in a new product which had never reached the market and the consequent strong dependence of licensees upon Aqua-Sonic for its development and manufacture, see 524 F.Supp. at 879.

Opinion of the United States District Court

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

80 Civ. 5513 (RWS)

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

against

AQUA-SONIC PRODUCTS CORP., ULTRASONIC DENTAL PRODUCTS, INC., LEON SCHEKTER, M. JOSHUA ABER, MARTIN HECHT, DENTASONIC, N.V., INVENTEL CORPORATION and MELVIN HERSCH,

Defendants.

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Opinion of the United States District Court

Sweet, D.J.

The Securities and Exchange Commission ("SEC") seeks a declaration that defendants Martin Hecht ("Hecht") and Inventel Corporation ("Inventel") have violated Sections 5(a) and 5(c) of the Securities Act of 1933 ("the Securities Act"), 15 U.S.C. §§ 77e(a) and 77e (c) ("the registration provisions"), and Sections 17(a) of the Securities Act, 15 U.S.C. § 77q(a), Section 10b of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder ("the antifraud provisions"). The SEC also seeks a permanent injunction barring the offering and sale of securities in the form of investment contracts. The declaration will be entered in the form of a judgment and the injunction will be granted as set forth below.

PRELIMINARY PROCEEDINGS

This action was commenced on September 30, 1980 by the filing of a complaint, and a motion for preliminary injunction was filed on December 19, 1980. The SEC sought to restrain the defendants, Aqua-Sonic Products Corp. ("Aqua-Sonic"), Ultrasonic Dental Products, Inc. ("Ultrasonic"), Leon Schekter ("Schekter"), M. Joshua Aber ("Aber"), Dentasonic, N.V. ("Dentasonic"), Melvin Hersch ("Hersch"), Hecht and Inventel from certain conduct about to be described. Discovery was expedited, the preliminary injunction motion was adjourned, and the defendants' motion for summary judgment seeking dismissal of the complaint for lack of jurisdiction was denied on June 3, 1981. Thereafter, all defendants except Hecht and In-

ventel entered into consent decrees and the SEC discontinued its action against them.[1] From June 10 to June 17, 1981 the SEC motion for preliminary injunction against Hecht and Inventel, the remaining defendants, was tried to the court and consolidated with the trial on the merits pursuant to F.R.Civ.P. 65(a). What follows are the court's findings of fact and conclusions of law.

Findings of Fact

The Enterprise

Arthur Kuris ("Kuris") and Aber were neighbors and friends, the former being an inventor and patent holder and the latter an attorney. Kuris had obtained patents applying the principles of ultrasonic wave propagation to various fields, one of which was dentistry. A device under the trade name of Cavitron was developed and marketed. The Cavitron gained wide acceptability among dentists and employed ultrasonic waves to dislodge plaque in the course of dental prophylaxis. The operation of the Cavitron required a coolant which was provided by a spray of water originating from the customary sources.[2] Kuris conceived

1. Final Judgments of Permanent Injunction by Consent were entered against defendants Aqua-Sonic, Dentasonic, Schekter and Aber on June 15, 1981, enjoining them from further violations of the registration and anti-fraud provisions in connection with any securities. Final Orders Pursuant to Stipulations and Undertakings ("Orders") were entered as to defendants Hersch and Ultrasonic, also on June 15, 1981, in which said defendants, under penalty of contempt, agreed not to violate the registration and anti-fraud provisions as to any securities in the future. Pursuant to said Orders, the action was dismissed as to defendants Hersch and Ultrasonic with the exception that the court retained jurisdiction over them to enforce the provisions of the Orders.

2. Indeed, as a discomfort and coincidence the court received an extra-judicial demonstration of the effective operation of a Cavitron during the course of this proceeding.

of an improvement of the Cavitron which would employ sterile water as the coolant for the ultrasonic process and would thereby reduce the risk of any contamination resulting from micro-organisms which might be found in tap water.

These new products for which Kuris held patent rights were termed Steri Products. One of the products, known as the Steri Prophy Unit, was designed as a complete, self-contained ultrasonic prophylaxis unit utilizing pre-packaged sterile water. The other Steri Product, called the Steri Satellite Unit, was designed to be affixed to existing dental equipment to supply pre-packaged sterile water.

After discussions with Aber, in early 1978 Kuris met with Aber's partners Hecht and Schekter to develop a plan to market and distribute these Steri Products. The lawyers had formed a professional corporation then called Schekter, Aber and Hecht, P.C. ("SAH"). As a consequence of these discussions, four corporations were established by Schekter, Aber and Hecht: Aqua-Sonic and Ultrasonic, New York corporations; Dentasonic, a Netherlands Antilles corporation; and Inventel, a Delaware corporation. Schekter, Aber and Hecht were the original shareholders of Dentasonic until November, 1978 when Kuris acquired a 19% interest. The shares in both Aqua-Sonic and Ultrasonic were held by sole shareholders, their respective principal officers. The original shareholders of Inventel were Schekter, Aber and Hecht until February of 1979, at which time the corporation redeemed the shares of Schekter and Aber, leaving Hecht the sole shareholder.

Immediately after incorporation, Dentasonic purchased from Kuris the patent and other related rights to the Steri

Products for the United States and Canada for $406,500 payable in installments. Kuris retained a security interest in the patent and other rights conveyed to Dentasonic. Dentasonic sold only the United States marketing and manufacturing rights to the Steri Products to Aqua-Sonic, which had been incorporated in April 1978, for $26 million pursuant to an agreement dated June 1, 1978, this sum to be paid not only from a percentage of the proceeds from the sale by Aqua-Sonic of licenses to sell the Steri Products, but also from a percentage of the profits received by Aqua-Sonic from actual product sales. Until payment of the $26 million Dentasonic retained a security interest in the rights conveyed to Aqua-Sonic, held certain voting rights to all of Aqua-Sonic's stock and was given a security interest in certain accounts receivable and contract rights, certain inventory and inventory records, equipment, inventions, patent rights and trademarks in all products and proceeds of Aqua-Sonic.

SAH developed certain materials for Aqua-Sonic describing its proposed method of doing business ("the promotional materials") to be set forth more fully below. In short, Aqua-Sonic proposed to sell to licensees the right to sell Steri Products in certain specified geographical areas. Ultrasonic was described as an optional sales agent for the licensees. Inventel, which was not described, entered into a letter agreement with Aqua-Sonic by which Aqua-Sonic agreed to pay Inventel $2.2 million, ostensibly as a finder's fee for bringing about the sale of the rights in the Steri Products from Dentasonic to Aqua-Sonic and for past and future consulting services. Under the letter agreement, Aqua-Sonic agreed to pay Inventel a portion of the pro-

ceeds from the sale of licenses and the sale of the Steri Products and related patents or trademarks.

The Promotional Materials

After the corporations were organized, in the course of the preparation of the promotional materials, SAH sought an opinion of another law firm, Messrs. Baer, Marks & Upham, with respect to the applicability of the securities law to the proposed enterprise. SAH received a memorandum in or about May, 1978 from an associate of that firm, Barry Mandel, a prescient lawyer as things have turned out, to the effect that the license arrangement might be considered an investment contract. The partners at SAH directed one of their associates to research the issue in the summer of 1978, and after considerable discussion concluded otherwise. The promotional materials were modified as set forth below and the enterprise proceeded.

A market consultant was retained and for $500 provided an analysis of the available market based primarily on the use of Cavitron, and the marketing practices in the industry which included the use of so-called dental depots, in effect, wholesale houses offering dental supplies to all kinds of dentists, a focal element in the licensing plan. Also, Kuris obtained and passed on to Hecht a letter from a Dr. Henry Goldman, an apparently well-regarded dental authority, which could be construed as an endorsement of the Steri Products. The letter was described succinctly by Hecht in his investigative testimony, who realized the need to overcome the resistance of dentists who were going to be told that their present machines were unhygenic. Hecht

likened their attitudes to those of the 19th century surgeons who would say to Pasteur "Get out of here Louis." In addition, an article in the Journal of Periodontology entitled "Microbial Contamination of Dental Units and Ultrasonic Sealers" was obtained.

Prototype models had been developed, and Logical Technical Services ("LTS"), an engineering firm specializing in electronic applications, was retained in late 1978 to convert them into finished marketable products.

With these preparations in hand or in contemplation, certain documents were prepared to be used in the enterprise. During the period from on or about May 1, 1978 through August 31, 1978, these promotional materials were developed and used in discussions with potential licensees or their representatives. These included:

(a) an Information Memorandum describing the Steri Products and the nature of the offering, with exhibits attached thereto including a tax opinion letter prepared by SAH and financial illustrations projecting sales of the products and revenues.

(b) the Aqua-Sonic license and security agreement and notes payable to Aqua-Sonic (prior to inclusion of the so-called Advertising Fund to be discussed below), and related instructions.

(c) a document entitled "An Offer to Act as Sales Agent."

(d) the Ultrasonic sales agency agreement, security agreement, and notes payable to Ultrasonic (prior to inclusion of the Advertising Fund), and related instructions.

(e) a reprint of the aforementioned article by Arthur Gross (and others) from the Journal of Periodontology.

(f) a four-page document entitled "Confidential for Professional Use Only."

During the period from on or about September 1, 1978 through October 31, 1978, the following documents were used in a two-pocketed packet, the second version of the offering package.

(a) a new Information Memorandum Relating to Exclusive Rights revised to reflect, among other things, certain management changes at Aqua-Sonic, the tax opinion letter and financial illustrations.

(b) the Aqua-Sonic license and security agreement and notes payable to Aqua-Sonic and related instructions.

(c) a document entitled "An Offer to Act as Sales Agent."

(d) the Ultrasonic sales agency agreement, security agreements, and notes payable to Ultrasonic and related instructions.

(e) two large professional photographs of what appeared to be a completed Steri Prophy Unit and Steri Satellite Unit such as would be sold.

(f) The Journal of Periodontology article.

(g) a copy of a letter dated September 12, 1978, to Aqua-Sonic from E. A. Greenlee, President of LTS, concerning the commercial production of the Steri Products.

(h) a copy of the letter dated August 22, 1978, to Kuris from Dr. Henry Goldman.

A third and final version of the materials in use after November 1, 1978, consisted of the documents contained in the second version plus the following documents:

(a) a letter dated November 1, 1978 signed by defendant Hersch with attachments relating to the creation of the Steri Products, Advertising Fund and supplemental tax opinion by SAH.

(b) a package of revised closing documents relating to the license, sales agency and Advertising Fund, and

(c) a revised summary of the offering entitled "Confidential for Professional Use Only—Summary of Revised License for Steri Products."

Licensees who had entered into the notes and agreements contained in the first two versions of the offering materials were asked to sign revised agreements and notes which conformed to the third offering package.

The Information Memorandum summarized the obligations of the licensees in the licensing agreement as follows:

> The License Agreement delineates the relationship between the parties and imposes specific duties and obligations on the Licensee. These duties include, but are not limited to: (a) vigorous promotion of the distribution and sale of the Products Parts and Supplies; (b) maintenance and employment of sufficient working capital and net worth to enable Licensee to fulfill all of his duties, obligations and responsibilities under the License Agreement; (c) employment of such agents, rep-

> resentatives and employees as Licensee in his sole discretion, may deem to be necessary to assist him in the performance of some or all of his duties and obligations as Licensee; (d) use and maintenance of an accounting and reporting system as may be required by Licensor; and (e) use of order forms designed by Licensor and (f) adherence to certain standards for advertising materials used in connection with the business.
>
> . . .
>
> Licensee will be an independent contractor and be solely responsible for all expenses and costs incurred by him in the conduct and promotion of his business. In addition, Licensee will be required to and be responsible for the vigorous and satisfactory promotion, distribution and sale of the Products, Parts and Supplies for use in his Territory so as to obtain a reasonable share of the market . . . In the event that a Licensee does not satisfactorily fulfill his duties and responsibilities as set forth in the License Agreement, Licensor may elect to terminate his License.

Although the Information Memorandum did not mention an offer by anyone to act as a sales agent, it did state that a licensee may retain "agents, representatives or employees" to assist in marketing the Steri Products, and added:

> The choice as to whether to deal with Dental Depots and/or to retain agents, representatives, employees or others is solely that of the Licensees. The Licensor takes no position on this matter, for the most effective means of achieving satisfactory market penetration will vary according to the prior experience of the Licensee, the amount of time and effort the Licensee is

willing to expend to exploit the License, and the nature of Licensee's Territory.

Annexed to the Information Memorandum as Exhibit H is a set of financial illustrations designed to demonstrate the potential profitability of the licenses. These illustrations assume that a potential licensee does not retain the sales agent. (A similar set of illustrations annexed to the offer by Ultrasonic to act as sales agent makes the opposite assumption.)

The Information Memorandum stated further:

> In the event that a Licensee, in his sole discretion, elects to retain and/or employ anyone to assist him in the performance of some or all of his duties, obligations and responsibilities under the License, Licensee must undertake to actively supervise their activities on his behalf to ensure that they perform their activities in a manner which will be consistent with Licensee's activities and responsibilities to Licensor.
>
> . . .
>
> In the event that a Licensee does not satisfactorily fulfill his duties and responsibilities as set forth in the License Agreement, Licensor may elect to terminate his License.

The Information Memorandum and the license application indicate that the license is available to a limited class of persons who are capable of performing all their obligations and exercising their rights under the license agreement, and if they so chose, the sales agency agreement. Under the heading "Who Should Apply for a License," the Memorandum stated:

> A License will be granted only to a person who has considerable knowledge and experience in financial and business matters, appreciates and understands the merits and economic risks of this business. Experience has shown that this type of business is not suitable for and should not be pursued by persons who lack substantial assets . . . .
>
> A License will be granted only to an Applicant in reliance on his representations and warranties that he has himself, or together with any business and financial advisor with who he may consult, knowledge and experience in financial and business matters, that he is capable of evaluating the merits and risks of this transaction, and that he is able to bear the economic risks of this transaction.

The license application provided:

> Applicant hereby represents and warrants as follows:
> . . .
>
> 4. Applicant and/or his designated representative has such knowledge and experience in financial and business matters, and investments in particular, that he is capable of evaluating the merits and risks of the Applicant's acquisition of a License and has obtained, in Applicant's judgment, sufficient information from Licensor relating to the License to evaluate the merits and risks of the contemplated transaction.

The "Offer to Act as Sales Agent," if accepted by the potential licensee, placed the responsibility for all sales of Steri Products for the benefit of a particular licensee in Ultrasonic. Certain rights, however, were retained by the licensee.

The Ultrasonic sales agency agreement provided that the licensee has the absolute "right to cancel this Agreement at any time upon ninety days' written notice" and that the agent:

> will uniformly maintain the prices established from time to time by Principal [licensee] for the Products, and conform to such terms of sale and other selling and ordering conditions as may be determined and required from time to time as herein provided.

It further provided that:

> All orders shall be subject to approval of items, price and credit by Principal and shall be confirmed by customers. All quotations for sales made by Agent to customers, or prospective customers, must be made expressly subject to the approval and confirmation of Principal and shall not be binding until such approval is given by Principal. All Products shall remain the property of Principal until sold.

and that:

> [B]ooks, records and copies of invoices shall be open at all times during business hours to the inspection of any duly authorized representative of Principal.

The Aqua-Sonic documents described over 100 geographical territories in the United States, and each standard territory was designed to contain approximately the same number of dentists, although there were larger territories available. The fee for a typical license under the License Agreement was $159,500 payable as follows: $9,150 in cash upon the granting of the license; $9,150 in the form

of a negotiable promissory note, bearing interest at 7% per annum and due January 15, 1979; and, $141,700 by a non-recourse promissory note, bearing interest at 6% per annum and due January 1, 1985, but requiring pre-payment based on a portion of the proceeds from the sale of the Steri Products. The initial term of the license expires on December 31, 1985; however, an option was included to extend the license for an additional five-year period. Under the license agreement Aqua-Sonic was solely responsible for the development and manufacture of the Steri Products.

The typical licensee under the sales agency agreement paid a $16,600 fee to defendant Ultrasonic, as follows: $500 in cash upon acceptance of the offer; $500 by recourse promissory note payable on January 15, 1979, and $15,600 by non-recourse promissory note due December 1, 1984, but requiring pre-payment based on a portion of the proceeds from sales of the Steri Products. In addition, defendant Ultrasonic was entitled to a commission of 20% of gross sales of Steri Products under the terms of the sales agency agreement.

During a later stage of the offering, SAH created the Advertising Fund to promote the Steri Products for investors and to increase the tax benefits available to them. The Fund was a joint venture to be administered by two clients of SAH, Hanson Fassler Associates, Inc. and Morris Baumstein Associates, Inc. Investors were required to make the following contribution to the Advertising Fund: $400 in cash upon obtaining the license; a $400 negotiable promissory note due on January 15, 1979; and a

$13,200 non-recourse promissory note due December 1, 1984, but requiring pre-payment based on a portion of the proceeds from sales of Steri Products. The addition of this mandatory contribution did not increase the overall price of a typical investment because the amount payable to defendant Ultrasonic under the sales agency agreement was correspondingly reduced by the amount payable to the Fund. Moreover, monies paid by investors prior to the creation of the Advertising Fund were reallocated from Ultrasonic to the Fund apparently at the direction of SAH through Aqua-Sonic.

After November 1, 1978 the Aqua-Sonic, Ultrasonic and Advertising Fund Agreements, and the notes relating thereto, were physically bound together and offered to licensees in a single package. The entire cost of the Aqua-Sonic enterprise for the typical licensee, including the Aqua-Sonic license agreement, the Ultrasonic sales agency agreement and the Advertising Fund was: $10,050 in cash; $10,050 in recourse promissory notes due January 15, 1979; and $170,000 in non-recourse notes due December, 1984 and January, 1985.

The tax opinion letter and supplementary materials stated that licensees could include the non-recourse notes, the cash payments and the recourse notes in their basis for amortization and that the licensee fee could be amortized over eight years. Licensees were further advised that they could deduct the full contract price of the sales agency agreement and Advertising Fund contributions during 1978 and 1979. Thus, a typical investor who was personally liable for $20,100 on his investment was advised that, as-

suming no sales of the products, he could take tax deductions of $38,400 in 1978 and $20,000 in 1979. Investors were informed that they would reecive additional tax benefits by retaining the sales agency. In addition to the described materials two letters were sent by Aqua-Sonic to all licensees instructing them how to treat their investment on their 1978 and 1979 federal income tax returns.

When an investor retained Ultrasonic, the sales agency agreements authorized Ultrasonic to perform all significant marketing functions, including finding customers, taking orders, collecting proceeds, and paying expenses and taxes. Additionally, the selling price of the products was to be agreed upon between Ultrasonic and the investor; however, Ultrasonic was authorized to reduce the sales price unilaterally so long as its commission on the sale was correspondingly reduced.

The Selling

The Aqua-Sonic licenses were offered and sold to investors throughout the United States. Hecht contacted financial planners, accountants, and attorneys throughout the country and recruited a number of individuals as commissioned salesmen, and with varying, not always successful, results. These individuals, some of whom were financial consultants for some of the licensees, received commissions for telling potential licensees about Aqua-Sonic, signing up licensees and transmitting properly executed agreements to Aqua-Sonic.

Many offering packages were distributed to salesmen and purchasers of the Aqua-Sonic offering from the South-

ern District of New York by making use of the means, instruments and instrumentalities of interstate commerce and of the mails. Generally, interstate commerce, the mails and telephones were used in connection with the Aqua-Sonic offering.

Hecht arranged sales meetings in various cities including Phoenix, Portland, Los Angeles, Denver, New York and San Francisco to recruit salesmen and solicit licensees and to describe the license and sales agency agreements and the tax consequences of the Aqua-Sonic offering. Kuris demonstrated the prototypes of Steri Products. In total, between May 1 and December 31, 1978, Aqua-Sonic investments were purchased by 50 licensees for approximately $12,100,000 of which $11,200,000 was in the form of non-recourse promissory notes and $900,000 in cash and recourse notes.

The testimony of eleven Aqua-Sonic licensees was taken through depositions outside the jurisdiction, one of whom, Rex Zimmerman, was also a salesman of the offering. Two licensees testified at trial. These individuals were, for the most part, well established in full-time careers and business endeavors or were retired and, with two or three exceptions, all possessing some knowledge of finance and investment and sufficient funds to employ that knowledge. Pursuant to the promotional materials the licensees were required to represent that each possessed net assets in excess of $100,000 and incom in the 50% bracket.

The licensees included members of SAH, the wife of one of the principals of the firm handling the advertising and promotion for Steri Products, and a number of people who

had engaged in over ten years of business transactions, a vice-president of a substantial public corporation with extensive business experience, the president of businesses related to the sale, production and use of asphalt products, a partner in the restaurant business, a shareholder of a small manufacturing corporation, the vice-president of a public service corporation, and a petroleum jobber, a dentist, a farmer, a computer analyst, a builder and seller of private homes, a corporate vice-president of employee relations, a retired schoolteacher, a school principal, a full-time physical therapist, the president of a data processing company, and retirees. None had any experience selling dental products and for the most part the territories of the licenses were not close to the residences of the licensees. Two or three of the licensees, Dorothy Baxa, Leonore Haas, and possibly Edward Abrahamson, did not read the described documents.

Most licensees testified they were primarily interested in an income-producing investment and a tax shelter and did not intend to become actively involved in the business. Moreover, some licensees were told or otherwise led to believe that, after making the initial payments in 1978 and 1979, they would have no further responsibilities and that no additional monies would be required. The availability of the sales agency to market the product was an important factor in certain of the licensees' decision to purchase the Aqua-Sonic license. Some investors did not distinguish between Aqua-Sonic and Ultrasonic and viewed the offering as a single package.

The promotional materials neither offered nor advised of the existence of any sales agent other than Ultrasonic

and in fact, although acceptance of Ultrasonic's offer to act as sales agent was purportedly an optional feature of the Aqua-Sonic offering, all Aqua-Sonic licensees executed the sales agency agreement. A fair construction of the promotional materials and the depositions indicate that Aqua-Sonic was responsible for the development and production of the products and Aqua-Sonic, Ultrasonic and the Advertising Fund for the marketing and promotion of the products.

The Operation of the Enterprise

David Glasser ("Glasser") became Aqua-Sonic's first president and sole shareholder primarily at the suggestion of Kuris and his advisors. Glasser resigned in or about August 1978 because, among other reasons, he was advised in an opinion letter written by his attorney that the offering might be a security under the federal securities laws and might involve violations of other laws, including antitrust and federal food and drug statutes. Glasser had also become concerned when he was asked to sign, on behalf of Aqua-Sonic a series of documents, including a note for over $25 million with Dentasonic. Following Glasser's resignation, Hecht in the summer of 1978 recruited a friend, defendant Melvin Hersch, to be president and sole shareholder of Aqua-Sonic.

Leonard Suroff ("Suroff") was recruited to be Ultrasonic's president and sole shareholder. Suroff was a practicing patent attorney who was recommended by Kuris and who had had some experience dealing with the dental supply depots. During the time Suroff was associated with

Ultrasonic, all checks were signed by Hecht or one of his law partners as well as by Suroff. Suroff never executed any sales agency agreements. Following Suroff's resignation in December 1978, as a consequence of the SEC investigation, Hecht recruited Melvin Ehrlich, a professor of physics, to be president of Ultrasonic. Ehrlich has been president and sole shareholder since that time.

At the time the Aqua-Sonic licenses were sold to investors, the Steri Products were in the prototype stage and required further development before they could be manufactured and sold. Aqua-Sonic had retained LTS to convert them into finished marketable products, and evidence was presented that in the summer of 1978 production early in 1979 did not seem unreasonable. However, the models given to LTS in late 1978 were incapable of delivering sterile fluid and required significant redesign.

LTS did developmental work on the early models which resulted in the creation of its first prototype model in late 1979 after the encountering of difficulties in obtaining certain of the ultrasonic components. However, the model was incapable of delivering sterile water. Various correspondence and reports from LTS advised Aqua-Sonic of the progress and problems in the development of the Steri Products. At about the time Hecht severed his relationship with Aqua-Sonic and became of counsel to SAH, in March 1979, Aqua-Sonic had a bank balance exceeding $250,000.

As of June, 1981 the units were still not ready for sale, since final production models had not been produced and for a period of one year until the spring of 1981 no work had been performed due to Aqua-Sonic's instruction that it would no longer pay LTS. Testimony at trial established

that additional changes are required to produce the Steri Satellite at an estimated cost of $8,000 to $10,000 plus the $36,000 and $78,000 required for hard tooling. The design and tooling will take an estimated 24 to 32 weeks. Soft tooling would cost less than hard tooling but the end product would be of much lower quality and the life of the tool itself would be short. In order to make the Steri Prophy Units into commercially marketable products, additional design changes would take approximately three months to make at an estimated cost of $15,000 to $20,000 and $61,000 to $118,000 for hard tooling. No clinical testing has ever been performed on either unit. The tooling for production has not yet begun and approximately $1,200 remained in Aqua-Sonic's bank account as of June 16, 1981. Furthermore, Aqua-Sonic's two-year agreement with Kuris' Creative Ultrasonics Corp. has expired and Kuris is no longer obligated to perform any more consulting services in connection with his inventions.

Misrepresentations and Omissions

Hecht and Inventel concede that if the licenses are held to be investment contracts, the securities laws were violated, initially, of course, by the failure to register the securities. It is also conceded that other information which would have been required was left out of the promotional materials, namely the interests of the named defendants, the role of SAH, and financial information relating to the corporations involved including the use of proceeds, commitment, working capital and the reduced price at which the licenses were offered to insiders. Of course, given the view of the license adopted by the defendants, no financial

information was supplied, and thus the categories of information just described, required to be included in offering materials, were omitted.

The market report upon which the tax opinion was based was produced within 24 hours on unverified information and was sufficiently superficial with respect to market factors, prices and amortization to make the tax opinion on which it was based misleading. The financial projections were similarly empty of objective support, and the product was not ready for market as represented. The absence of any clinical testing of the Steri Products was not set forth, nor was the research adequate to permit reference to the underlying "definite casual relationship" claimed between the use of unsterile water and various infections. The photographs of the Steri Products carried the implication that th[illegible] were the finished product when in fact they were prototypes incapable of performing their professed prophylactic function. All these matters constituted misrepresentations or omissions of material facts required if the licenses are considered to be securities.

The Role of Hecht and Inventel

Hecht participated in the discussions which led to the formation and structure of the enterprise and the preparation of the described materials by the law firm of which he was a member. He attended meetings at which the enterprise was discussed in order to explain the transactions, both to those who would seek to interest licensees and licensees themselves. He assisted in the recruiting of officers of Aqua-Sonic and Ultrasonic. For services in organizing the selling effort, Inventel, of which Hecht had been the sole

shareholder since February, 1979, received $200 and has rights to substantial additional funds to be divided among Hecht, Schekter and Aber, if the enterprise goes forward based upon Hecht's efforts.

In Hecht's own words, "I was trying to sell the sellers." He did so in significant ways, including the dissemination of the SAH opinion letter concerning the application of the securities laws to the enterprise. He also participated not only in the selling and the structuring of the transaction but SAH, during the time he was a member, initially served virtually all administrative functions for Ultrasonic and Aqua-Sonic, kept the books, bank accounts and prepared correspondence. Although Hecht was not an officer, director or employee of those corporate defendants, as a partner of SAH he participated in the administrative activities just described in addition to his selling and personnel activities.

The Role of the SEC

In 1978 the SEC initiated inquiries concerning the enterprise, requested information and received by September, 1978 certain of the requested documents. In 1979 investigative examinations were conducted. Hecht's for example, took place on August 29, 1979. This action was commenced in August, 1980 and the motion for preliminary injunction was made in December, 1980.

THE ISSUES

From the outset of this proceeding, Hecht's skilled counsel has urged that but two issues have been presented: (1) wehther the court has jurisdiction, and if so, (2) what relief is appropriate. Both parties have concentrated primar-

ily on the first issue, whether or not the Aqua-Sonic offering of a license, coupled with an offer by Ultrasonic to act as a sales agent, constituted the offering and sale of an "investment contract" under the rules laid down in *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946). According to Hecht and Inventel, this is a case of first impression. At the least, it is one more of a long line of cases presenting the difficulties of determining the essential elements of an "investment contract."

Since the described materials were drafted to avoid the very issue now raised by the SEC, an additional threshold issue is presented by the claim of the SEC that the evidence relevant to the jurisdiction issue includes not only the knowledge and intent of the defendants but also the state of mind and capacity of the licensees beyond that which is proclaimed in the described materials and reflected in the licensee's answers to the Aqua-Sonic questionaires. There lies in this issue the troublesome taint of an ex post facto determination, a revisionist view of the transaction, resulting from attitudes contrary to those expressed on paper at the time the transactions at issue took place.

Conclusions of Law

The Relevant Evidence

It is already the law of this case by virtue of the denial of defendant's motion for summary judgment that the economic realities of the transaction are controlling, not simply the documents which constitute the formalities of the transaction involved. The authorities for that proposition were cited in the court's opinion of June 5 and need not be reiterated.

The enterprise and the described materials, by the very nature of the operation of the securities laws, must be examined as of the time that the transaction took place, together with the knowledge and the objective intentions and expectations of the parties at that time. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852-53 (1975); *Piambino* v. *Bailey*, 610 F.2d 1306, 1320 (5th Cir. 1980), *cert. denied*, 101 S.Ct. 568 (1980); *SEC* v. *Int'l Scanning Devices*, [1977-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶96,147 at 92,171-175 (W.D.N.Y. 1977). The subjective intentions or motivations of the investors are irrelevant. *Piambino* v. *Bailey, supra*. To the extent that subsequent events give rise to inferences that are relevant to the economic reality of the transactions at the time they occurred, they were considered, but only to that extent. The LTS discussions, correspondence and projections in 1980 and 1981 do not give rise to such inferences though they may be relevant to the question of relief.[3] Similarly, the SEC's proposed findings relative to the operation of the dental supply depots is disregarded beyond that which was contained in the described materials. No probative evidence was offered in this connection, nor could any findings be made concerning the ability of the licensees to conduct their proposed business in the absence of actual experience which was precluded by the march of events.

In fact, no sales of the products occurred and no opinion evidence was offered that such sales could or could not have occurred in the contemplated manner even if the prod-

3. Even for that purpose, the testimony is of doubtful use, given the extent of the consent decrees already entered into which appear to preclude Aqua-Sonic's resumption of business.

ucts had been available. Although Mr. Abrahamson might have intended to retire to Maine where his franchise is located, and although Mrs. Baxa and others had purchased franchises across the country from their home, there was insufficient evidence upon which it could be found, as opposed to surmised, that the licensees were not capable of vigorously promoting the sale of Steri Products as they had warranted to do. It is significant, however, both in terms of relief and in terms of contemporaneous construction, to note that after the defendants received the Mandel memo, indicating the possible applicability of the securities laws, the language casting responsibility on the licensee was further strengthened and reinforced while none of the operative feature of the enterprise was altered.

Finally, perhaps the most significant determination in terms of evidence of economic reality is the definition of the enterprise. Hecht and Iuventel seek to limit the evidence—and consequently the court's consideration—to the promotional materials, the license to sell the patented products and the offer of Ultrasonic to perform that task, subject to the licensees' control, right to know, and capacity to cancel the services of Ultrasonic on stated terms and conditions. In the felicitous example of counsel for the defendants, the license is likened to the independent dealership for the sale of automobiles which has yet to be termed by the SEC, or anyone else, an investment contract. Were the inquiry and the evidence so limited, perhaps the defense would prevail, but if all the facts relevant to the enterprise as it operated in 1978 and early 1979 are considered, including the capitalization, stage of development of the Steri Products, tax consequence, and method of operation, the

economic reality differs materially from the exemplary automobile dealership. It is those facts, pressed forward by the SEC under the criteria set forth in the authorities that compel the declaration that the license agreement and sales agency executed by the licensees constituted an investment contract.

The Relevant Criteria

Howey is the obvious starting place, and its three criteria for determining an investment contract are easily stated: (1) an investment of money, (2) in a common enterprise, (3) on an expectation of profit to be derived solely from the efforts of the promoter or third parties. Here the input of money and the common enterprise are conceded and the profit element is only slightly in conflict. The principal field of battle between the parties has been in their contentions concerning the efforts of others. The defendants place their chief reliance on the promotional materials, which clearly state that the licensee has the right to sell the Steri Products without using Ultrasonic as a sales agent, without reliance upon sole efforts of the promoter or third parties. They urge further that, even having contracted for the services of Ultrasonic, the Aqua-Sonic licensees retained substantial rights, powers and duties. The SEC contends to the contrary, claiming that the economic reality dictated sole or very substantial reliance on others.

Early on in the development of this line of cases, the requirement that the profits be the result of the sole effort of the promoter or a third party was modified to "undeniably significant" efforts of others. *SEC* v. *Glenn W.*

Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The Court of Appeals for our circuit has cited *Turner* with approval in *Glen-Arden Commodities, Inc.* v. *Costanino*, 493 F.2d 1027, 1035 (2d Cir. 1974) and affirmed Judge Neaher when he employed the *Turner* modification in *SEC* v. *Galaxy Foods, Inc.*, 417 F. Supp. 1225, 1239 (E.D.N.Y. 1976), *aff'd mem.* 556 F.2d 559 (2d Cir.), *cert. denied*, 434 U.S. 895 (1977). *See also Williamson* v. *Tucker*, 645 F.2d 404, 418-19 (5th Cir. 1981). I conclude therefore that Hecht and Inventel do not escape the "efforts of others" criterion by reliance on the word "solely." It is the significance of the efforts of others to produce the profits that must be established.

Even under the narrow interpretation of the enterprise urged by defendants, namely, the conduct of the business of the licenses to sell Steri Products, viewed realistically, any profits would have resulted from the efforts of others. All licensees signed the Ultrasonic sales agency agreement and all thus retained Ultrasonic to sell the Steri Products. Whether or not certain licensees might also have exerted efforts to sell will never be known, given the terms of the consent decrees. The sales agency agreement itself, and the showing as to its actual centrality to the entire scheme, constitutes significant evidence, in the absence of contrary testimony, that the efforts of others would be "undeniably significant." However, the enterprise in its totality consisted of far more than the sales agency. No sales could be achieved absent the product to be sold, and for that—the development of the Steri Products from the rough prototype stage—the licensees were entirely dependent on Aqua-Sonic, a dependence which could not be relieved from

any other source. *See Galaxy Foods, supra,* 417 F. Supp. at 1241-42.

There is a series of cases cited by the SEC where the sale of a franchise or a commodity with the offer of services have been held to be investment contracts. *Glen-Arden Commodities* v. *Costantino, supra; Continental Marketing Corp.* v. *SEC,* 387 F.2d 466 (10th Cir. 1967), *cert. denied,* 391 U.S. 905 (1968); *SEC* v. *Brigadoon Scotch Distributors, Inc.,* 388 F. Supp. 1288 (S.D.N.Y. 1975); *SEC* v. *Galaxy Foods, supra; see also SEC* v. *W.J. Howey Co., supra.* Hecht and Inventel cite cases where a sale of a franchise or land together with the offer of services has been held not to constitute an investment contract where purchasers have retained non-illusory rights or powers, *Schultz* v. *Dain Corp.,* 568 F.2d 612 (8th Cir. 1978); *Fargo Partners* v. *Dain Corp.,* 540 F.2d 912 (8th Cir. 1976); *Mr. Steak, Inc.* v. *River City Steak, Inc.,* 460 F.2d 666 (10th Cir. 1972), *affirming* 324 F. Supp. 640 (D. Colo. 1970); *Chapman* v. *Rudd Paint & Varnish Co.,* 409 F.2d 635, 641 (9th Cir. 1969); *Wieboldt* v. *Metz,* 355 F. Supp. 225 (S.D.N.Y. 1973); *see generally Williamson* v. *Tucker, supra,* 419-21, 424-25.

The criterion by which these two lines of cases can be reconciled has been stated to be passivity, *Galaxy Foods, supra,* 417 F. Supp. at 1241, dependence, or latent investor control, *Williamson, supra* at 421. Because of the nature of the products being offered, the character of the sales agency and the nature of the industry to be served, the Aqua-Sonic licensees were dependent, passive and incapable of latent investor control, or, in other words, unable to exercise whatever powers over the enterprise they formally retained.

Another criterion has been advanced by the SEC, then tentatively withdrawn, the so-called "risk capital" basis which has evolved under the California and Hawaii Securities laws, *see Stanley* v. *Commercial Courier Service, Inc.*, 411 F. Supp. 818, 821-22 (D. Ore. 1975); *Wiebolt* v. *Metz, supra*, at 259-62; *Mr. Steak, supra*, 324 F. Supp. at 646; and has been the subject of considerable commentary, *see Forman, supra*, 421 U.S. at 857 n.24. While this approach has not been accepted in the federal courts as a substitute for the classic *Howey* test, nor is it so embraced here, in my view such a theory can be subsumed under the "efforts of others" test of *Howey*, or as an extension or further definition of passivity or dependence. *See Stanley, supra*, at 823; *Wiebolt* v. *Metz, supra*, at 260-61. What is really at issue in this formulation is whether the enterprise more closely resembles a traditional offer to invest, to put money at risk dependent on the efforts of others, or the purchase of a right to conduct a business those resources are or practically can be controlled by the purchaser, not by the seller. Here, the cash used to purchase the license, some $900,000, was, on the basis of this record, the only cash in the enterprise. True, Aqua-Sonic possessed some know-how and patent rights, but the only operating capital, as the term is commonly understood, came from the payments of licensees. There were no bank loans, stock issues, notes or any other financing made available to Aqua-Sonic. On this record I am not reluctant to conclude that a risk capital approach is helpful, and that under such a criterion, the described materials constituted an investment contract. However, such a conclusion merely buttresses the conclusions already set forth; perhaps consideration of the risk

capital concept merely casts the criteria of passivity and dependence in somewhat more traditional terms, traditional at least in the commercial, if not the legal, world.

The economic reality here is that the fuel which drove this enterprise as far as it went was the concept characterized by Hecht as a TABA:

> 'I don't like to use the term 'investment': This year [1979] I call what I do a TABA which is a tax advantage business acquisition, because, literally, the individual is still acquiring a business and it is only through the method of his acquisition that he obtains tax benefits. In this particular case [Pool Patrol] the structure of the acquisition of the license gives tax benefits (Hecht Investigative Transcript at 102).

The defendants offered a tax shelter and sought to make it possible for the licensees to take advantage of the tax provisions described in the tax opinion contained in the described material. This tax treatment was the emphasis of the selling effort and the questionnaire, and apparently the underlying motivation of the licensees. The year-end discussions between Mr. Abrahamson, on the way to the opera, and his accountant, placed in clear outline the principal feature of the enterprise—its tax effect. The defendants sought by the form of the transaction to make the enterprise a business and not an investment contract, a TABA and not a security. The economic reality was otherwise.

The defendants, perhaps perceiving the drift of the authorities, urged this case be treated as one of first impression with unique facts. When pressed for the authorities closest on the facts defendants cited *Williamson* and *Mr. Steak*. To the same inquiry, the SEC responded *Galaxy*

Foods. The difference in the factual setting of each of the cases cited seems to this court to reinforce the conclusions reached above. A restaurant franchise or an undivided interest in realty could be managed as an independent business and possessed features other than those identified with a traditional investment. The franchised sale of groceries depended much more heavily on the ability of others to obtain and deliver the goods. Here, as it in fact turned out, the licensees were totally dependent on defendants not only for the merchandising of Steri Products, in which arguably the licensees could have been involved, either practically or as a matter of right, but also upon Aqua-Sonic for the products to be sold. Finally, the only source for funds for such production was the payment by the licensees. Although structured as a TABA, it turned out to be an investment in which the licensees were at risk and where in reality there was no latent investor control of the enterprise nor any evidence of the existence or exercise of such control other than the nominal right to sell the products without Ultrasonic, a right which I conclude failed to constitute control.

The Relief

Defendants have urged that the relief to be granted, if any, for the violations—conceded and found—must meet the strictures of *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90 (2d Cir. 1978), *affirming* 410 F. Supp. 1002 (S.D.N.Y. 1977), a proposition not seriously challenged by the SEC. In determining whether or not to issue a permanent injunction the Honorable Lloyd F. MacMahon in *Commonwealth* listed the factors to be considered. 410

F. Supp. at 1020, a listing which was quoted with approval by the Court of Appeals, 594 F.2d at 100. These included a finding of liability for illegal conduct, the degree of scienter, whether the occurrence was an isolated one or not, contrition, and whether, because of his professional occupation, the defendant might be in a position where future violations could be anticipated.

Obviously, the liability has been found although Hecht and Inventel are expected to continue their assertions that the licenses were not investment contracts.[4] At the same time, the defendants throughout have been straightforward and candid in their acknowledgment that no attempt was made to comply with the securities law and have consistently conceded a violation of those laws by way of a failure to register, for example, if it is concluded, contrary to their contention, that the enterprise involved an investment contract. Of course, that concentrates the issue on the heart of Judge Friendly's opinion in *Commonwealth*, scienter and the likelihood of similar future conduct.

On three occasions Hecht was made aware that other members of the bar viewed the enterprise as one that might be required to comply with the securities laws. The memo of the associate of the Baer Marks firm was rendered to SAH specifically with respect to this issue. Glasser and Suroff, the first presidents of Aqua-Sonic and Ultrasonic, resigned, stating that their counsel had raised questions concerning the applicability of the securities laws and a letter was shown to Hecht to that effect. Finally, of course, the inquiries of the SEC itself constituted notice of the

4. The issue here is not that of a good faith defense, which was held wanting by the Honorable Edward R. Neaher in *Galary Foods*, but rather the closely related scienter and future intent.

possibility of the impending litigation. However, the unfavorable memorandum by the Baer Marks associate was reviewed by a SAH associate, the authorities were apparently discussed and the SAH partners reached a different conclusion. Whatever their secret convictions may have been, there is no direct evidence of a knowing violation.

Nevertheless, in the context of this case, under the law of this circuit, recklessness would amount to scienter. *See Oleck* v. *Fischer*, 623 F.2d 791, 794 (2d Cir. 1980). Here two outside firms rendered opinions contrary to the final SAH conclusion. The SAH conclusion was bottomed on research and analysis by an associate who, it must be inferred, knew the details of the enterprise including the financial interests of his employer partners. Not to have obtained another outside opinion and to rely on the opinion of financially interested attorneys must be considered reckless under these circumstances, so reckless as to constitute scienter.

What then remains is the most significant of the factors, the likelihood of future violations by Hecht, who through his counsel, professes an abandonment of the practice of law. (As far as his relationship with SAH, this has been established.) Hecht seems equally adamant in his intent to continue the offering of TABA's, whether those known to the SEC as a consequence of this investigation—the sale of the pool alarm system or the ultrasonic toothbrush—or other similar enterprises. A reading of Hecht's investigative transcript reveals a man who has obtained new knowledge of an area of opportunity—the TABA—including an identification of others who participate in the merchandising of such acquisitions. The blurring of definitions of these acquisitions and investment contracts is amply

demonstrated by this litigation. It can therefore be inferred that there is a likelihood that Hecht could again err, to view it charitably, in the same fashion as he has done here. Therefore the requirements of *Commonwealth* have been met and a permanent injunction will issue.

What really is at stake, one suspects, is not the opprobrium attached to District Court determination of a securities act violation in a difficult and evolving area of the law but rather the procedural consequences which would flow from a permanent injunction and a contempt citation which might flow from the injunction, were the SEC and Hecht to differ in the future on the essential character of a TABA which he might seek to sell. Obviously, every effort should be made to fit the terms of any injunctive relief to the violation found to have been committed, particularly here, where the argument has been advanced with some force that even the SEC took over a year, or almost two, depending on when one starts counting, to conclude that Hecht and the other defendants had acted in violation of the securities acts. It is to be hoped that the SEC will help the court to clarify, or at least characterize, the conduct to be enjoined, by a description of the prohibited conduct in specific rather than general terms.

A judgment will be submitted on notice within ten (10) days.

IT IS SO ORDERED.

Dated: New York, N.Y.
August 7, 1981

/s/ ROBERT W. SWEET

ROBERT W. SWEET
U.S.D.J.

Judgment of the United States Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of June one thousand nine hundred and eighty-two.

Present:

HON. HENRY J. FRIENDLY
HON. IRVING R. KAUFMAN
HON. LAWRENCE W. PIERCE
Circuit Judges

#81-6231

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

v.

AQUA-SONIC PRODUCTS, CORP., ULTRASONIC DENTAL PRODUCTS, INC., et al.,
Defendants,

MARTIN E. HECHT and INVENTEL CORP.,
Defendants-Appellants.

Appeal from the United States District Court for the Southern District of New York.

Judgment of the United States Court of Appeals

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellants.

A. Daniel Fusaro, Clerk

by /s/ Edward J. Guardaro
Edward J. Guardaro,
Deputy Clerk

Statutes and Rules Involved

Section 2(1) of the Securities Act of 1933, 15 U.S.C. 77b(1)

§ 77b. Definitions

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * *

Sections 5(a) & (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) & (c)

§ 77e. Prohibitions relating to interstate commerce and the mails

(a) Sale or delivery after sale of unregistered securities

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate com-

merce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

• • •

(c) Necessity of filing registration statement

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a)

§ 77q. Fraudulent interstate transactions

(a) Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * *

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(10)

§ 78c. Definitions and application

(a) Definitions

When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's

acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

* * *

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b)

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Commission Rule 10b-5, 17 CFR 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.